VZCZCXYZ0002
OO RUEHWEB

DE RUEHSN #1241/01 3042042
ZNY CCCCC ZZH
O 302042Z OCT 08
FM AMEMBASSY SAN SALVADOR
TO RUEHC/SECSTATE WASHDC IMMEDIATE 0254
INFO RUEHIN/AIT TAIPEI 0088
RUCPDOC/DEPT OF COMMERCE WASHINGTON DC
RUEATRS/DEPT OF TREASURY WASHINGTON DC

C O N F I D E N T I A L SAN SALVADOR 001241

SIPDIS

STATE FOR WHA, EEB
TREASURY FOR DAS ONEILL, LTRAN, SSENICH

E.O. 12958: DECL: 10/30/2028
TAGS: EFIN ECON PGOV ES
SUBJECT: EL SALVADOR'S FINANCIAL/LIQUIDITY CRISIS: THOUGHTS ON THE WAY FORWARD

REF: A. SAN SALVADOR 1238
¶B. TEGUCIGALPA 937

Classified By: CDA Robert I. Blau, Reasons 1.4(b) and (d)

¶1. (C) El Salvador faces a serious short-term financial and liquidity crisis, driven by the cost of government subsidies, domestic political uncertainty, and the international financial crisis (reftel A). In the short-run, the Government of El Salvador (GOES) may be able, with assistance from the U.S. Treasury, improve liquidity through addressing structural defects in the financial markets. In the long-run, however, a solution will require improved fiscal discipline, increased confidence between the government and investors, and an accord on external debt between the political parties. END SUMMARY.

¶2. (C) Approximately $450 million in short-term government debt will come due before the end of the Saca Administration on May 31. Banks and investors are no longer willing to roll over short-term debt, preferring to increase liquidity in the face of international constraints and domestic political uncertainty, and lacking confidence in the government's fiscal responsibility. The government's need for new debt in a limited domestic market is also putting upward pressure on interest rates, and its fiscal constraints prevent it from using fiscal policy to combat an economic slowdown or recession. The banking sector warns of the risk of possible bank runs driven both by concerns over domestic political instability and the international financial crisis. While the banking sector has positioned itself well in terms of reserve funds, the banking association is not confident that it can contain a bank run. (Reftel A.)

¶3. (SBU) The GOES's inability to issue new short-term debt (Letters of Treasury, commonly known as "Letes") prompted the government to request emergency technical assistance from the U.S. Treasury. From October 20-22, Treasury's Office of Technical Assistance (OTA) team and Econoff met with GOES officials including: Manuel Rosales, Director of Fiscal Policy, Investment, and Public Credit, Ministry of Finance; Carlos Salazar, Director of Treasury, Ministry of Finance; Luis Maria de Portillo, President of the Central Bank of Reserve; Sonia Gomez, Director of the Financial System, Central Bank; Luis Aquin, Director of Studies and Statistics, Central Bank; and Guillermo Funes, Deputy Technical Secretary to the President. Outside the government, the team met with: Manuel Enrique Hinds, former Minister of Finance; Dr. Armando Arias, President of ABANSA (private banking association) and Amcham; Macela de Jimenez, Executive Director of ABANSA; Luis Membreno, Economist, Financial Consultant and former advisor to the Minister of Finance; Rafael Barraza, former President of the Central Bank; Carmenza McLean, Country Representative of the Inter-American Development Bank; Gijs Veltman, President of Citibank El Salvador; and Mauricio Choussy, Executive Director of Fitch Ratings in El Salvador.

THOUGHTS ON THE WAY FORWARD

¶4. (C) None of the GOES officials or outside observers the team met could offer a clear solution. One problem is that no one could identify the full scope of the problem -- how much does the GOES owe for all its short term debts, not just the Letes, how much new borrowing will the GOES need to do before June 2009, and how liquid or illiquid the government actually is. This has contributed to the loss of investor confidence, as have the public statements by the Minister of Finance about the GOES's inability to borrow. Former Central Bank President Rafael Barraza commented that one of the first things the GOES needs to do is "eliminate the noise" in the market. This may mean, he added, that the Minister of Finance stops talking to the press entirely.

¶5. (C) Manuel Hinds proposed that the GOES create a "liquidity committee," led by a strong figure (he proposed former Central Bank President Rafael Barraza) who could ensure that the Ministry of Finance and Central Bank undertook measures the committee deemed necessary. According to Deputy Technical Secretary Guillermo Funes, the GOES has already convened a "liquidity commission" including theTechnical Secretary, the Ministry of Finance, the Cntral Bank, and the state-owned Multi-Sector Invstment Bank. Funes could not explain, however, wat the commission's roles and responsibilities wuld be.

¶6. (C) One proposal by the Ministry of inance would force

the "semi-autonomous institutions" to pull their time-deposits out of the commercial banks and put them into Letes. Former Central Bank President Rafael Barraza thought such a plan could work if it was implemented correctly, e.g., if the Ministry notified banks two months in advance that certain deposits would be withdrawn. The more likely scenario, however, was that the Ministry "would call the banks up the night before and say they're pulling out all this money," which would cause panic and havoc in the system. Economist Luis Membreno doubted that there was even much money left in the semi-autonomous institutions to tap, since the GOES had already used them to buy the bonds from the various trusts, shore up Banco Hipotecaria, and buy some of the October offering of Letes.

¶7. (C) Another scenario that concerned the private sector, according to Citibank President Veltman, was the GOES seizing and effectively expropriating the private banks' reserves, held by the Central Bank, and using them to buy Letes. This would make the entire system's liquid reserves illiquid.

¶8. (C) Director of Fiscal Policy Manuel Rosales also said that Central American Bank for Economic Integration (CABEI) had offered the GOES $300 million in June, but the GOES had only accepted $100 million (Note: CABEI has so far only provided $50 million, with another $50 million expected by the end of October. End Note.) In Rosales' opinion, if CABEI comes through with an additional $200 million to buy Letes then the GOES "wouldn't have any problems." In Luis Membreno's view after studying CABEI's balance sheet, however, CABEI simply doesn't have the funds to bail out every country in Central America, despite reports that it's promised $400 million to each country (reftel B).

¶9. (C) Another possible "solution" is a bailout by a foreign government. Former Finance Minister Manuel Hinds speculated that the reason President Saca, in Hinds view, was not taking the situation very seriously was because Saca ultimately expected President Bush and the USG to bail him out. ABANSA/AmCham President Armando Arias suggested that the GOES might ultimately turn to Taiwan. Others suggested that, should the FMLN win, they'll look to Venezuela. Former Central Bank President Rafael Barraza noted that the trusts, created by the ARENA government, would "provide the perfect vehicle" for Chavez to legally pour money into El Salvador.

¶10. (SBU) In the short run, corrections to structural problems in the markets could help bring more liquidity to Letes, which would help lure back investors. Currently, El Salvador's repo market functions poorly, if at all. Similarly, an over-the-counter market for Letes does not exist, and a secondary market is almost non-existent. If the markets could be restructured such that banks could trade Letes, making them more liquid, they might be more inclined to buy. The Central Bank has been evaluating various options but has not reached any decisions.

¶11. (SBU) All financial experts the team met agreed that the Central Bank needed to obtain contingency lines of credit to guarantee liquidity in the financial system. According to Rafael Barraza, under the dollarization law the Central Bank is authorized to act as lender of last resort under "emergency circumstances." He understood the GOES had issued a decree declaring such an emergency, but it does not appear to have been publicized.

COMMENT

¶12. (C) Treasury's OTA team will offer specific recommendations on how to address the current fiscal and liquidity situation. In the short run, the GOES has to cross two big hurdles -- December and March, when the largest amounts of debt come due. In the long-run, any solution will require a political element. First, the GOES must restore fiscal discipline, especially on subsidies, and not continue to spend like it can still print money. Second, the government and the financial sector will need to sit down and work on ways to restore confidence between the two. Finally, the ruling ARENA party and the opposition FMLN will need to come to some sort of accord on approving external debt, so that El Salvador can roll over and refinance debt in a normal, fiscally sound way.

¶13. (C) It is not clear whether the Saca Administration has

the political will to address these long-term issues, or if it will try to patch things just enough to get past the 2009

elections, leaving a fiscal and financial mess for the next government to clean up. The risks of a short-term only strategy are two-fold. First, it leaves the economy and financial sector especially vulnerable to external shocks, which could come at any time, including before the elections. Second, in the event of an FMLN victory, it could both strengthen the hand of the more radical economic wing of the party and open a door for Chavez. END COMMENT.
BLAU